SECURITIES INDUSTRY ASSOCIATION

TRENDS

An Analysis of Emerging Trends in the Securities Industry

Produced by the SIA Research Department

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RETROSPECTIVE ON THE EIGHTIES; PERSPECTIVES FOR THE NEXT DECADE

Substantial changes occurred in the securities industry during the Eighties. This issue of Trends focuses on and quantifies these changes while attempting to put into perspective what these changes portend for the industry in this century's final decade.[1/]

Growth & Contraction During the Eighties

The Eighties were a decade of fantastic growth for the securities industry but more recently, a time of contraction and consolidation. Average daily volume on the Big Board climbed from just tens of millions of shares in the Seventies to 189 million shares per day in 1987. This fell back 14% last year and recovered slightly by about 4% in 1989 (**Exhibit 1**).

The over-the-counter markets grew even faster, with NASDAQ daily volume rising from single-digit millions in the Seventies to 150 million shares per day in 1987. This also fell back last year, by 18%, but recovered half that loss in 1989.

1/ Based on a presentation by Adrian L. Banky and Jeffrey M. Schaefer at SIA's 1989 Annual Convention. SIA welcomes contributions to Trends from all sources, including member firms and other sources on subjects relating to the securities industry and capital markets. Please send submissions to the attention of Jeff Schaefer or George Monahan, SIA Research Department.

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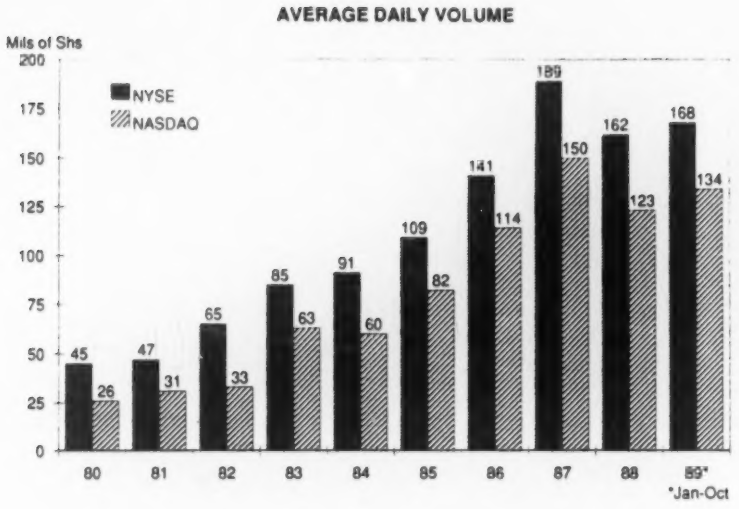
EXHIBIT 1



Any yardstick will show the growth of the securities industry in the Eighties. Industry revenues more than tripled from 1980 to 1986, going from $16 billion to $50 billion, but then stayed flat for the next two years. This year should show record industry revenues of about $60 billion - but these are not evenly spread among types of firms and have become increasingly risk-based, principal business driven.

Another growth/contraction area is employment. Since the October 1987 crash, employment has dropped sharply in the securities industry. For NYSE firms dealing with the public, total employment has declined from 262,000 as of September 1987 to 227,000 as of September 1989, or 13% (**Exhibit 2**). Although half of this decline was completed by 2Q88, further cuts have been announced recently.

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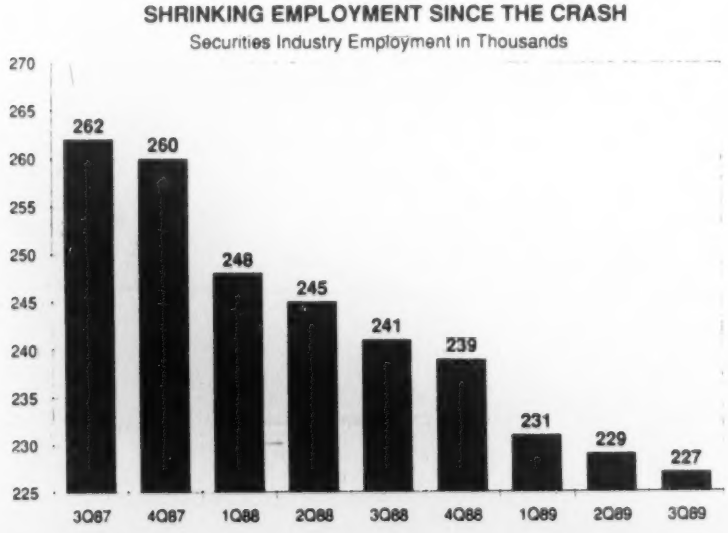

Though industry employment is down at least 35,000 in the two short years since the October 1987 crash, a look back at the early Eighties shows a dramatic increase in securities industry employment. The number of employees increased from 140,000 at year-end 1980 to 227,000 at 3Q89 (**Exhibit 3**), with a peak of 262,000 during 3Q87. Employment exploded by almost two-thirds during the decade despite the post-crash layoffs.

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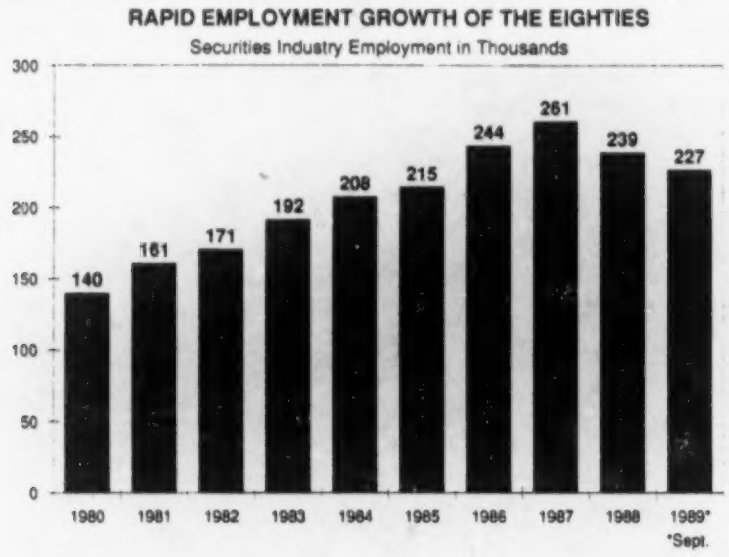
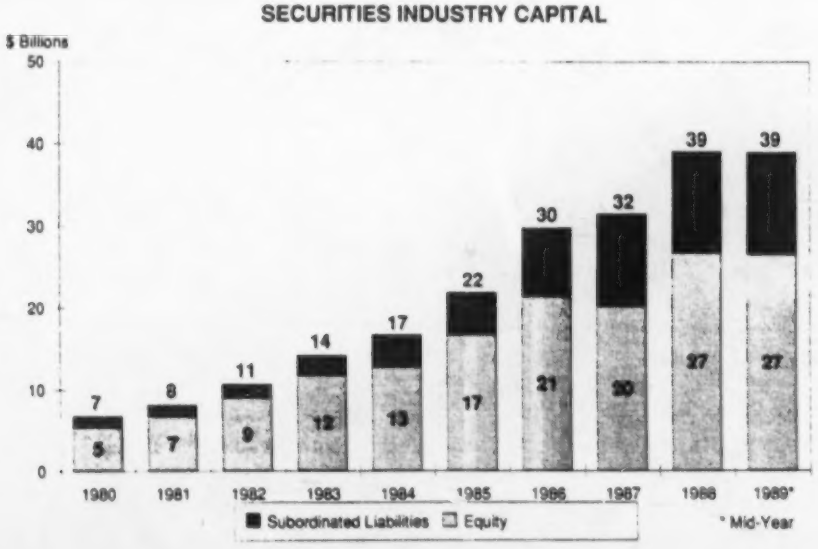


Exhibit 4 shows how industry capital (equity plus subordinated debt) quintupled from $7 billion in 1980 to $39 billion today. And this just includes the broker-dealer units of NYSE members. Excluded from the numbers is capital at the holding company level which increased sharply in recent years according to the reports of publicly held companies.

EXHIBIT 4



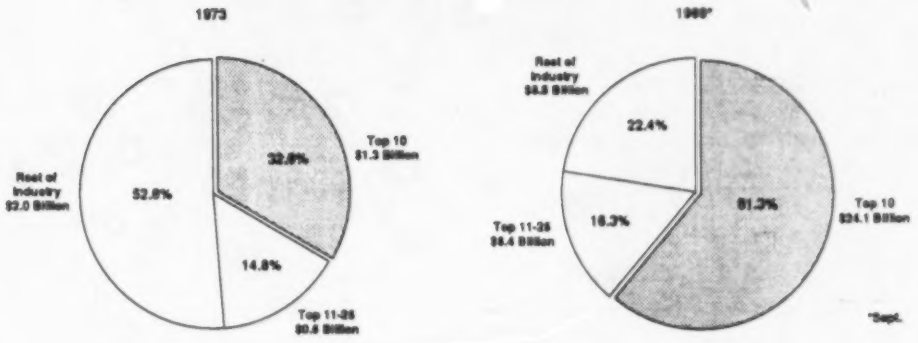
The demand for capital increased greatly during the Eighties as the industry, particularly the larger multinational firms, delved deeper and deeper into their own pockets to finance principal businesses - trading, merchant banking, bridge loans, sole-managed underwritings, participation in ownership of commercial enterprises, etc.

When the self-supplied capital became scarce, a new supply came from a rash of IPOs - we now have about three dozen publicly held SIA members vs a handful in the Seventies. Also, alliances with other institutions, particularly insurance companies, and most recently large Japanese intermediaries, have become an important source of capital.

This capital growth has been throughout the industry but, again, not evenly distributed. **Exhibit 5** shows how the largest 10 capitalized broker-dealers had just over $1 billion of capital in 1973 -- or 33% of the industry total. By September of this year, the largest ten's capital had grown 18-fold and accounted for over 61% of the industry's capital. The fifteen next largest firms had a 10-fold increase in their capital over this time span and maintained their same 15-16% share of industry capital. Meanwhile, the bulk of the industry in terms of number of firms had less than a five-fold increase in capital. In 1973, the rest of the industry, 419 firms, accounted for over half of all industry capital. This year, they account for 22% of the total.

EXHIBIT 5

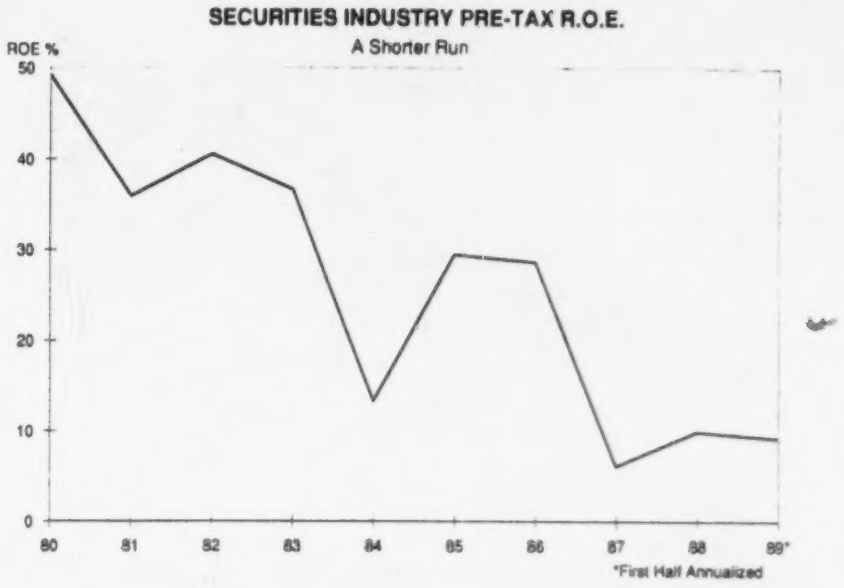
SECURITIES INDUSTRY CONCENTRATION
% Share of Capital



Recently, some concerns have been voiced that the industry is becoming over-capitalized. Certainly the diminishing returns being earned on the growing capital base may indicate that the industry has too much capital, or at least that it not being employed effectively.

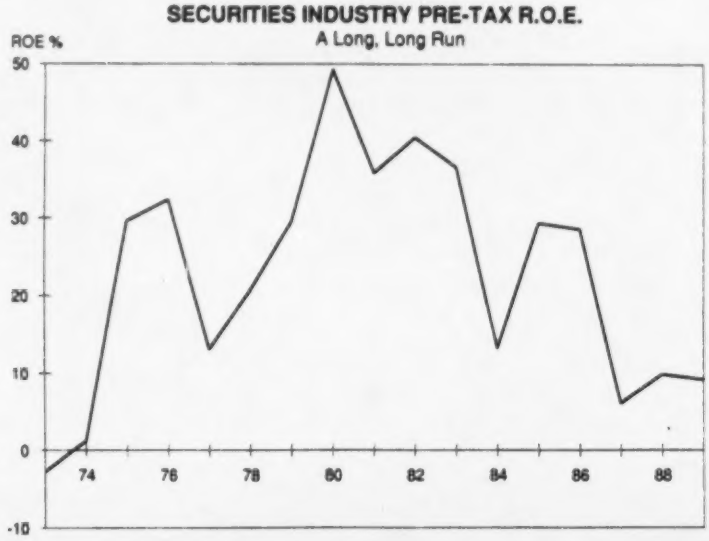
During the Eighties, industry ROE plummeted from a high of 50% in 1980 to a dismal of 6% - 10% since the crash (**Exhibit 6**). The downward trend was well under way during even the very good years in the early-to-mid Eighties. This trend coincided with the capital build-up and raises the question of can additional capital generate as high a ROE as the first units of capital. It is not easy to manage larger organizations so they are as efficient in generating profits as they were when they were much smaller.

EXHIBIT 6



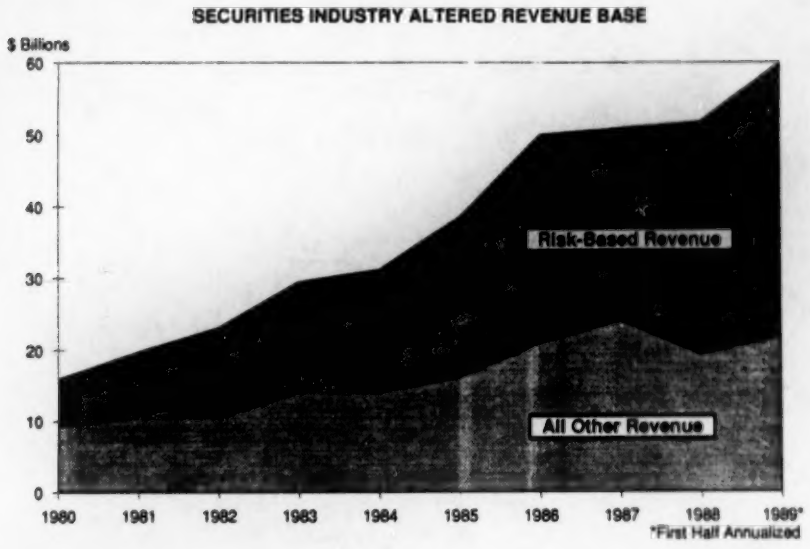
An even longer-term look at ROE back to the 1970s suggests that we may simply be in the downward part of a cyclical earnings pattern in this industry (**Exhibit 7**).

EXHIBIT 7



Also, additional capital may be employed not in less productive businesses, but rather that the industry's traditional, non-capital intensive businesses were dragging overall earnings and ROE down. In fact, for most firms, the more profitable segments of the industry in recent years have been those that are most capital intensive. Risk-based revenues now account for almost two-thirds of all industry revenues and that trend seems to be inevitably growing (**Exhibit 8**).

EXHIBIT 8



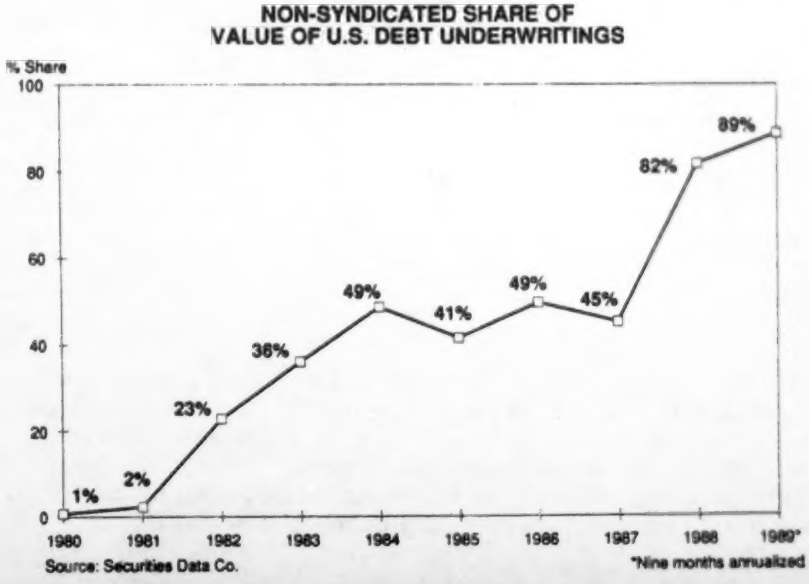
This trend implies that instead of being overcapitalized, firms may require even more capital if they seek to pursue the more profitable segments of the industry in the Nineties.

These risk-based revenues include: underwriting and trading revenue combined with "other securities related" revenues (private placements, M&A fees and interest revenues other than margin interest).

Not only have these risk-based revenues increased relative to other revenue sources, they increasingly are becoming more concentrated among the largest firms because of the heavy capital commitment most risk businesses require.

The trend towards principal trading and merchant banking has also helped change the way other business is done. For example, 89% of the value of bond underwritings so far in 1989 are completed without syndicates (**Exhibit 9**). That

EXHIBIT 9

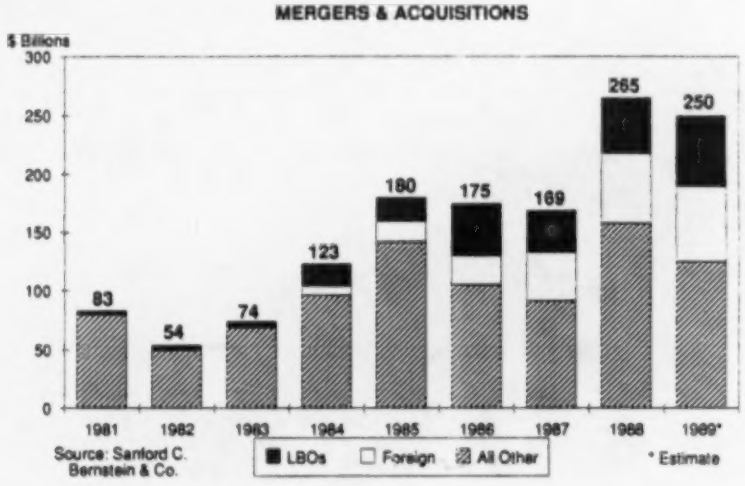


compares with under 50% from 1984-1987 and even smaller percentages in earlier years. Even one-third of equity underwritings are now completed without syndicates, although this level has remained more or less constant throughout most of the Eighties.

Of all the risk-based businesses, one of the fastest growing segments for the securities industry this decade is related to merger and acquisitions (M&A). Although dominated by National Full Line firms, Large Investment Banks, boutiques and money center banks, M&A has contributed a large and growing portion to the industry's bottom line -- and not just from direct advisory fees. Firms are now taking equity positions in these deals, providing bridge loans, underwriting high yield bonds and earning a host of other ancillary fees.

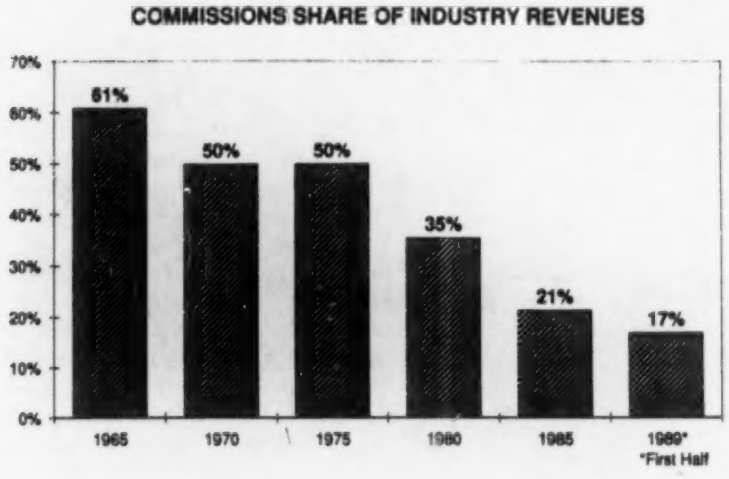
Although there has been some recent leveling off in this area, even if the most profitable segment, LBOs, begins to quiet down, the fastest growing segment, cross-border M&A, is now showing the fastest growth and is sure to be a major profit center in the 1990s (**Exhibit 10**). Japanese and European direct investment in the U.S. is just now beginning to soar, and with the recent events in Eastern Europe and the hope for the EEC in 1992, the potential for future cross-border M&A is very promising.

EXHIBIT 10



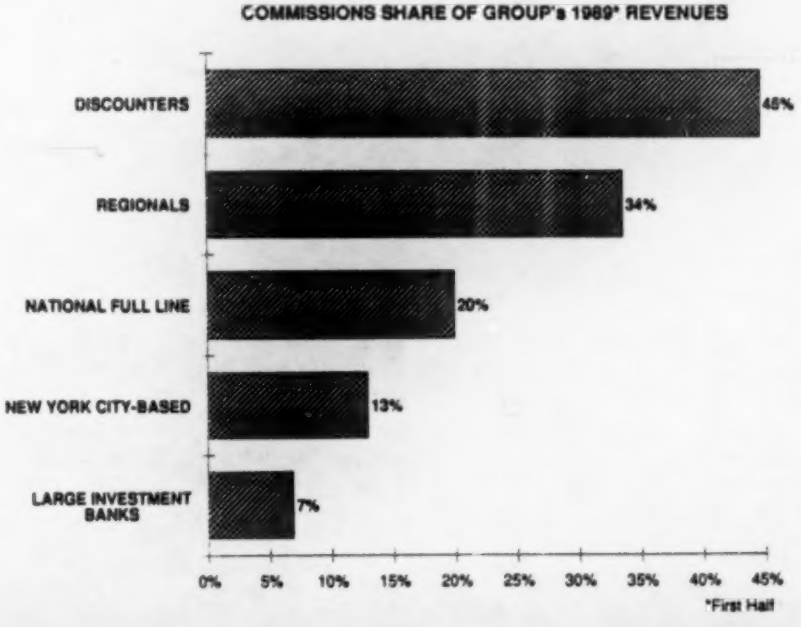
The growth of these risk businesses has dwarfed the growth in traditional businesses, primarily commissions. This trend, combined with the declining relative importance of equities domestically and U.S. equities internationally (not to mention the proliferation of other products), has led to a decline in the importance of the securities industry's traditional largest revenue base, commissions. **Exhibit 11** shows that over 60% of all revenues came from commissions in 1965. Today, commissions account for not even 17% of total industry revenues.

EXHIBIT 11



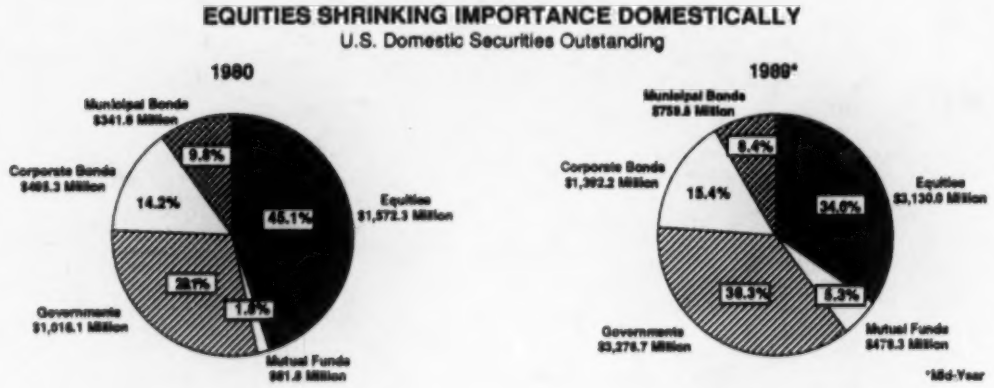
This 17% is partly due to other fast increasing business lines of the largest, dominant firms - - Large Investment Banks and National Full Line Firms - - where commissions account for only 7% and 20% of total revenues, respectively (**Exhibit 12**). Regional firms still derive one-third of their revenues from commissions, but even discounters today are reporting less than half of their revenues as equity commissions. Principal market making, including OTC positioning, accounts for some of the loss of the importance of exchange listed commissions, but the move to principal markets in debt instruments and fee-based revenue growth accounts for most of the change.

EXHIBIT 12



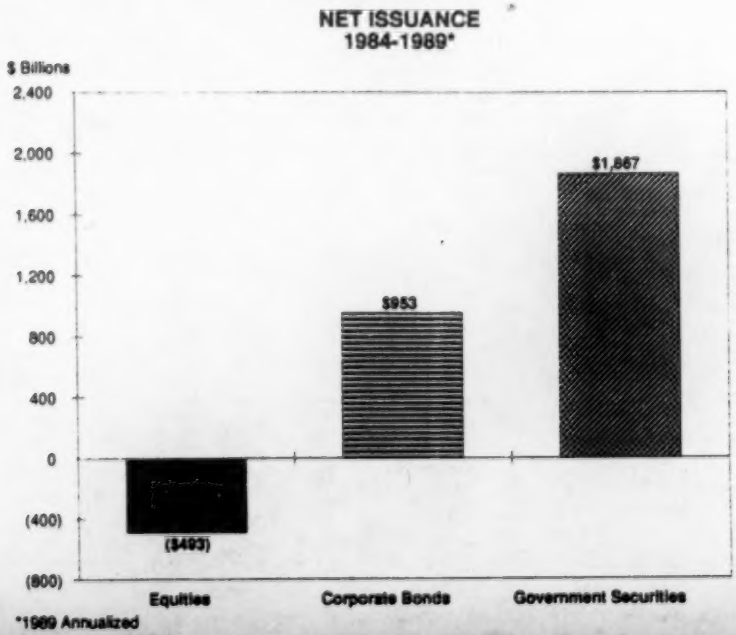
There are other implications for firms concentrating on the equity commission business. Marketable securities held by U.S. investors, both institutional and retail, almost tripled from $3.5 trillion outstanding in 1980 to $9 trillion as of mid-year 1989. But, again, the growth has been uneven, across securities. Equities, which historically dominated all securities outstanding, accounted for nearly half of the value of all securities in 1980 (**Exhibit 13**). By mid-year 1989, equities fell to the #2 security, behind U.S. Government securities, mainly Treasuries, and accounted for only a third of the outstanding value of all securities.

EXHIBIT 13



This shift in the importance of equities is a basic change in our capital markets and has been triggered by the shrinking supply of equities (**Exhibit 14**). However, this trend may have limits. Leverage today may be no higher than in some past years but it is relatively high. The markets are showing some unease with

EXHIBIT 14



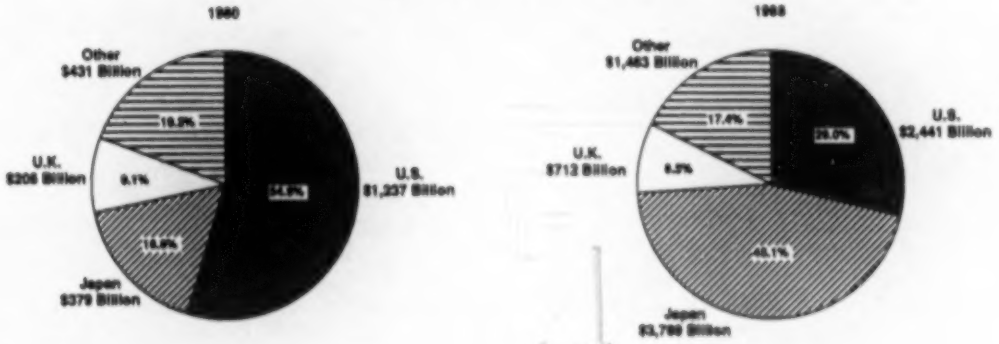
recent leverage levels, i.e. the skittish junk bond arena. At some point, equities may return to favor, particularly if tax laws are revamped to fall more in line with the tax treatment of equities in most other developed countries.

Equities not only have fallen in relative importance in the U.S. market, but their once premier position in the world has been eclipsed. In 1980, U.S. equities commanded 55% of the world's equity market capitalization and Japan only 17%. Last year, Japan's capitalization gave Tokyo a 45% share of world equities and the U.S. a mere 29%! (**Exhibit 15**) U.S. equities did grow but only two-fold while most of the world grew four-fold and Tokyo grew 10-fold! Part of Tokyo's growth has been the strengthening of the Yen in the Eighties, but this has not been the most significant factor. With no end to Japan's growth in sight, with Europe slated to be a block in 1992, with the recent "equitization" of Europe, and with the enormous potential of European growth with East meeting West, the U.S. may never again dominate the equity scene as in earlier years and this will be a major consideration for institutional and retail investors.

EXHIBIT 15

U.S. EQUITIES SHRINKING IMPORTANCE GLOBALLY

Global Equity Markets Capitalization

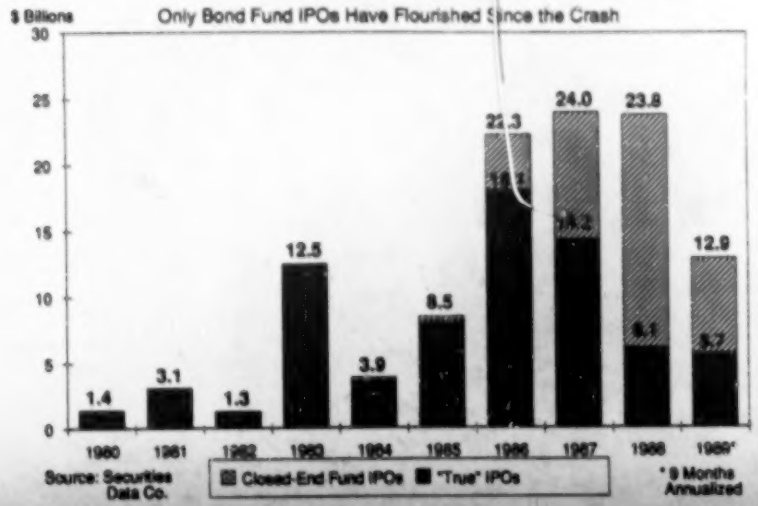


Since the 4Q87 crash, there is another factor affecting the decline in equities -- a dramatic drop in initial public offerings (IPOs). (**Exhibit 16** shows how "true"

EXHIBIT 16

"TRUE" IPOs HAVE CRASHED SINCE THE CRASH

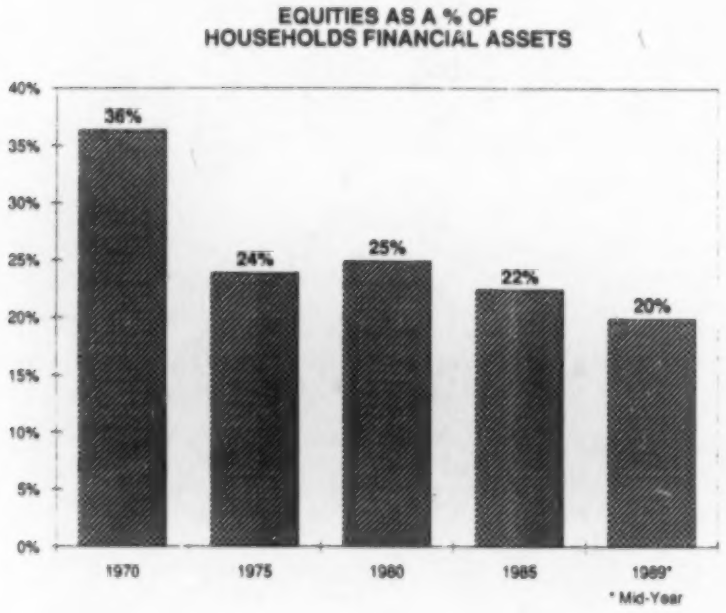
Only Bond Fund IPOs Have Flourished Since the Crash



IPOs, companies going public and not including the recent surge (and now decline) of closed-end bond fund IPOs, has dropped to less than one-third their 1986 peak.

On the retail side, equities have also become a less important part of household's financial wealth over time -- dropping from 36% of financial assets in 1970 to under 25% by 1975 and down to 20% as of mid-year 1989 (**Exhibit 17**). This decline in relative importance occurred despite the value of stocks held directly by households growing from less than $700 billion in 1970 to over $2 trillion by mid-1989. Although households' equity value did grow, other financial assets held by households increased faster during this time span.

EXHIBIT 17

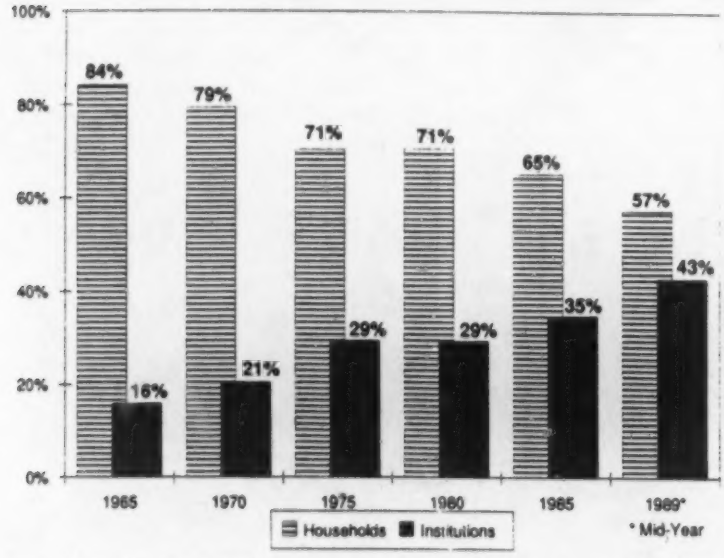


Where has the individual investor gone? Certainly, in the 1980s, households turned to those products offering attractive real interest rates. Money market funds enjoyed spectacular popularity. And, as individuals' direct holdings of equities dwindled, they were replaced to a certain extent by shares in mutual funds. Combined as a part of individuals' financial assets, these two investment vehicles grew by 17-fold between 1970 and 1989. Meanwhile, equities were the slowest growing component of individual assets, growing three-fold.

While individuals own a smaller share of equities directly, institutions own a larger share. Institutional ownership of equities has risen from 16% in 1965 to 43% by mid-1989 (**Exhibit 18**). For the equity markets, this has led along with other factors, to less liquidity and greater volatility.

EXHIBIT 18

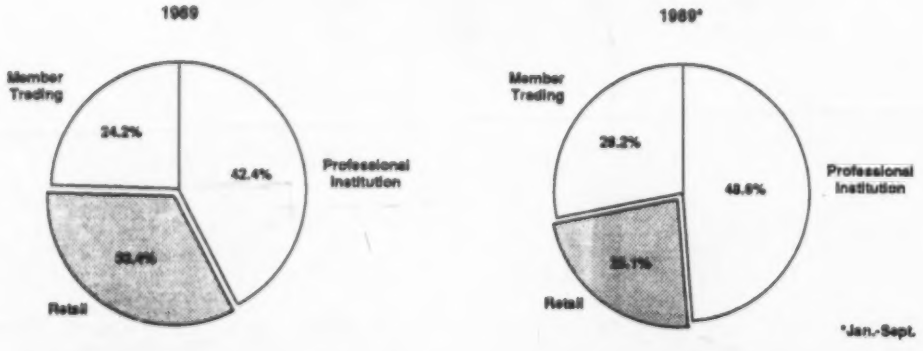
HOLDINGS OF U.S. EQUITIES



In addition, together with member firms trading as principal, institutional trading has gone from two-thirds of NYSE volume in 1969 to just under 80% during 1989 (**Exhibit 19**).

EXHIBIT 19

PROPORTION OF NYSE SHARE VOLUME



The institutional business has also put severe pressure on firms' profit margins. Many firms are now unwilling to put capital at risk for block positioning given the plunge in institutional rates, and now there is a movement underway to unbundle research from commissions. A key question for the securities industry of the 1990s will be how to serve institutional customers while maintaining adequate profit margins.

As individual participation waned and institutional participation waxed, the equity market declined in relative importance as a capital raising mechanism. Corporations have turned increasingly to debt financing as net withdrawals of equities began in the mid-1980s and accelerated. As we've seen (**Exhibit 14**), by the end of 1989, almost $500 billion in equities will be withdrawn from the public markets while almost two times that amount of corporate debt will have been raised.

The future capital structure of corporate America may more closely resemble that of German and Japanese companies. However, those companies have very different relationships with their banks and governments which may be completely inappropriate for the U.S. where we want a separation of banking and commerce. The growth of institutionalized assets, the rise of index funds and other "non-fundamental" trading strategies have led to serious questions about the efficiency of pricing in our equity markets. However, the recent shakiness in the high yield bond market is starting to make many uneasy with the amount of debt accumulated by U.S. corporations and government.

While the individual investor has fled the market and corporate America turns more and more to debt financing, there is one sector with a growing appetite for U.S. equities -- and debt as well. **Exhibit 20** shows that, excluding the corporate demand for shares, foreigners are now the #2 net buyers of U.S. equities. This has been true over the long haul (the shorter bar for yearly average 1980-89) and even more so more recently (taller bar, 85-89). Foreign customers, therefore, may continue to be a growth base for the 1990s as in the 1980s.

EXHIBIT 20

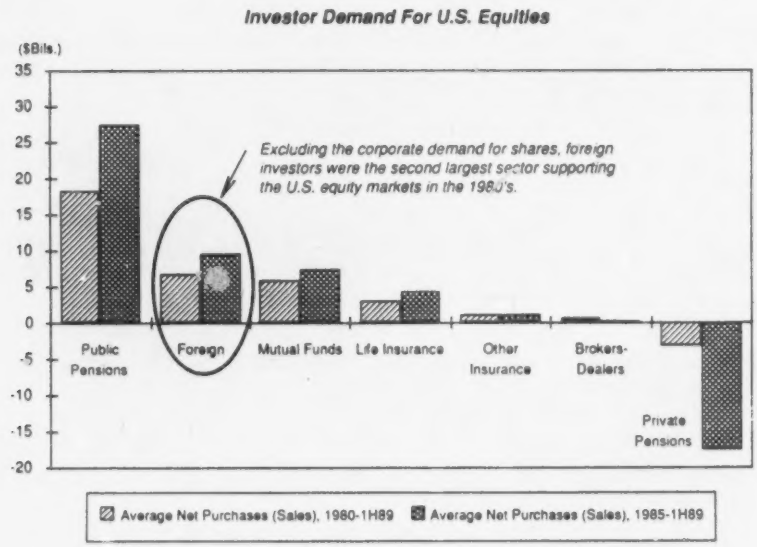
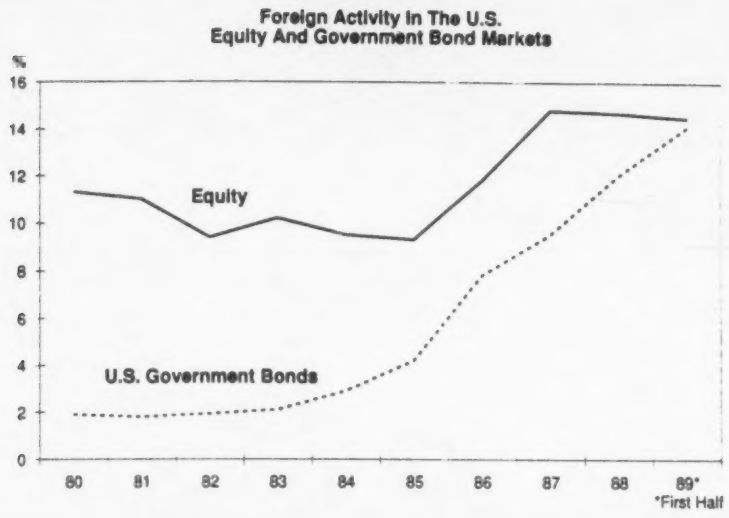


Exhibit 21 also shows how important foreigners have become to our U.S. equity markets -- recently accounting for 14% of the total trading done in the U.S. But the most recent rapid growth in foreign gross activity has been in the U.S. government bond market.

On an aggregate basis, foreign activity in governments has climbed from just under $100 million in 1980 to nearly a $4 trillion annual pace this year. Foreigners now account for over 14% of Treasury sales handled by primary dealers in the U.S. Indeed, Japanese and British firm names now pepper the short list of firms allowed to be primary dealers in Treasuries. As for T-Bills alone, there is now just over $2 trillion outstanding in the world with nearly $400 billion in the hands of foreigners. That is equal to two full years of federal government deficit spending.

EXHIBIT 21



With so much of our nation's debt in the hands of foreigners, can we have a truly independent monetary policy that doesn't take into account what the foreign demand for Treasuries is? The answer is obviously no. For instance, if the U.S. took an extreme action which caused Japanese institutions to unload their Treasury holdings in any sizable fashion, the Treasury would have to double interest rates in order to complete its next weekly auction!

The 1990s will see a more globally oriented economy and securities industry. The recent events in Eastern Europe will make this even more dramatic -- in ways which are very unpredictable. The securities industry does not now, and will never again, resemble exactly its history. The future success stories will come from firms which carve out a profitable niche in the increasingly global, diversified financial service industry of the Nineties.

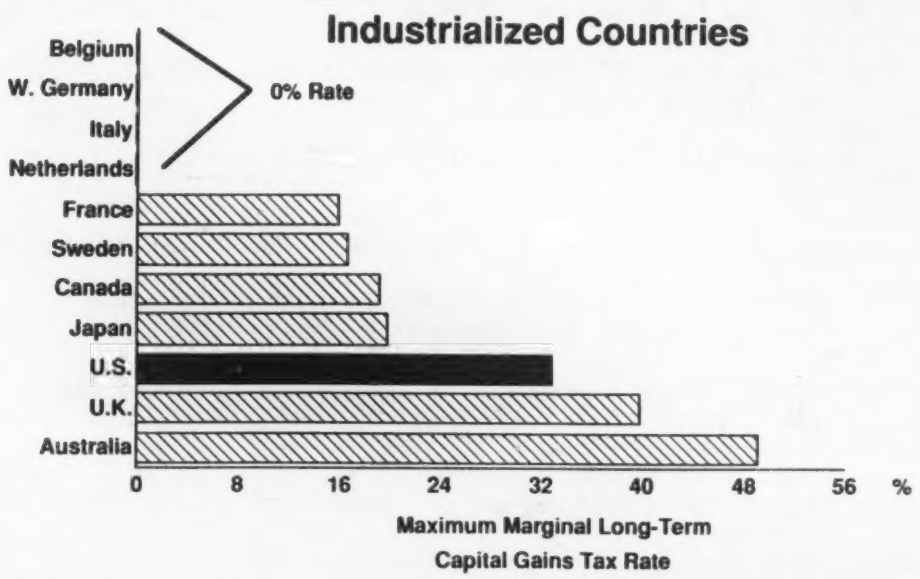
The loss of the individual investor to the equity markets is a loss to all. Retail investors are a key buffer to the markets -- they buy and hold for real quality and for the long run. This is important to everyone.

The 1986 tax reform act exacerbated the exit of individual investors at the same time as it spurred greater corporate reliance on debt financing. By eliminating targeted tax incentives for savings and investment, that act eliminated distinctions on income from risk and riskless investments.

America's major international competitors have recognized the need to encourage equity investment by individuals. Of ten OECD countries studied in a recent tax survey published by SIA,[2/] four completely exempt long-term capital gains and four apply rates lower than the U.S. (**Exhibit 22**).

2/ Securities Industry Association and Spicer & Oppenheim, International Tax Comparisons, 1989.

EXHIBIT 22



Moreover, the double tax on dividends is alleviated by some form of corporate integration in eight of these countries (**Exhibit 23**). In general, savings and investment incentives are found specifically in the tax codes of most major countries - except the U.S.

EXHIBIT 23

U.S. One of Few to Double Tax Dividends

	Corporate/ Shareholder Integration
[illegible]	No
Australia	*Yes*
Belgium	*Yes*
Canada	*Yes*
France	*Yes*
West Germany	*Yes*
Italy	*Yes*
Japan	*Yes*
Netherlands	No
Sweden	No
United Kingdom	*Yes*

The downward trend in the U.S. personal savings rate in the 1980s, the lack of participation in our equity markets by individual investors, and the increasing emphasis on global competition raises more than a few questions about our national policy towards savings and investment.

In summary, the Eighties, particularly since the 4Q87 have not been all moonlight and roses. Nevertheless, we must remember the many positive trends that occurred during this decade including:

1) volume on the NYSE almost quadrupling while activity on NASDAQ more than quintupled;

2) employment increased by almost 90,000 employees, or two - thirds;

3) capital quintupled to almost $40 billion for broker-dealer units only;

4) the industry is critical to the restructuring of corporate America which is absolutely vital to the global economy of today;

5) the revenue base has diversified and exploded from $16 billion in 1980 to $60 billion in 1989;

6) the value of equities on the NYSE has grown from $1.2 trillion in 1980 to $2.4 trillion as of mid-1989 despite an estimated $500 billion being withdrawn from the marketplace since mid-1983 because of corporate restructurings; and

7) the U.S. capital markets have become truly international as foreign investors have been attracted to them by their liquidity, rules of fair play, and opportunities.

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